

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 390

June 2, 1975

COOPERATIVE: EFFECT OF PAYMENT OF FEDERAL INCOME TAX LIABILITY ON CALIFORNIA FRANCHISE TAX

Syllabus:

Advice has been requested concerning the effect of payment of additional federal income tax on a farmers' cooperative association's California franchise tax, and the ability of a farmers' cooperative association to establish nontaxable reserves.

Payment of additional federal income tax by a farmers' cooperative association will not necessarily affect the cooperative's California franchise tax. The effect of payment depends on the nature of the funds used to pay the federal liability. This point may be illustrated by a simple example.

A farmers' cooperative association not exempt under federal law reports for federal and California tax purposes that all its income was derived from cooperative activities, and that all the income was offset by allocations to members pursuant to Sections 1382(b) and 1388(a) of the Internal Revenue Code and Section 24404 of the Bank and Corporation Tax Law.

Later, additional federal income tax is assessed when it is determined that part of the income allocated to members was derived from noncooperative activities. (Int. Rev. Code § 1382(c); Int. Rev. Code, Reg. § 1.1382-3(c)(2).)

Since Section 24404 authorizes a farmers' cooperative association to deduct all properly allocated income, the cooperative's current California franchise tax obligation would not be affected by the federal assessment per se. Whether the cooperative's franchise tax is affected at all will depend on the nature of the funds used to pay the federal assessment.

If current income is used to satisfy the federal tax liability, it follows that income available for allocation to members pursuant to Section 24404 will be reduced. Since federal income tax is not deductible (Bank and Corporation Tax Law, § 24345(a)(2)(a)), the use of current income, unless offset by some other deduction, would increase the taxable income reportable on the cooperative's current California franchise tax return.

Payment of the federal tax liability from equity capital amounts, such as proceeds from the sale of membership certificates or levies against members, would not have any California franchise tax consequences during the year of

payment or preceding years.

Payment may be from reserves established for the purpose of paying federal income tax. Farmers' cooperative associations are authorized to establish reserves pursuant to Section 54175 of the California Agricultural Code, however, the Bank and Corporation Tax Law provides a deduction only for reasonable additions to a reserve for bad debts (Section 24348). The tax treatment of other reserves, such as a reserve created to pay federal income tax, depends again on the types of funds deposited in the reserves.

The creation of reserves from equity capital amounts would not generate California franchise tax. On the other hand, unallocated amounts of income from cooperative and noncooperative sources are subject to the franchise tax whether or not deposited in reserves. Reserves may not be used to shield cooperative income from state taxation..